Non-Income Taxpayer Project Cover Letter Of March 29, 2012

Sheldon/Shirley - This correspondence is submitted on behalf of the American Council of Life Insurers, the American Insurance Association and the Property Casualty Insurers Association of America. ('the Trades"). The submission specifically deals with four aspects of the current Non-Income Taxpayer Project as outlined and discussed below.

1) It reiterates the insurance industry's strong belief that if this project is even necessary, the potential abusive use of an insurance company to evade taxes should be its focus. From the outset of this project the industry has made it clear that we believe the tax treatment of LLCs and partnerships owned by insurance companies cannot be separated from the rationale for and truly unique nature of the premium/retaliatory tax system imposed on the insurance industry. When viewed holistically as it should be, the insurance industry reasserts there is no issue of equity.

2) It provides feedback on an important aspect of the Executive Committee's discussion at last July's annual meeting that focused on whether tools already exist that can be used or enacted by states to address overcapitalized insurance companies/abuses.

3) As requested by the Executive Committee at the annual meeting last July, it provides revised draft model language aimed at addressing the potential abusive use of an insurance company to evade taxes.

4) It responds to the Uniformity Committee's February 10 request for additional analysis of potential retaliatory tax implications as a result of the project's current model language.

Project Focus

During the last several Uniformity Committee calls, it became clear that a difference of opinion exists as to the focus of this project. The Uniformity Committee seems to feel the project should deal strictly with the question of equity. Or to put it another way, that the treatment under the corporate income tax system of the income of certain LLCs and partnerships in which an insurance company invests must somehow be the same as afforded a non-insurance company investor, notwithstanding that the insurance company is subject to a distinct state tax system.

However, the Trades have opined that the focus should be, not on this so-called "tax equity" issue, but rather on the potential abusive use of an insurance company to evade taxes. The Trades' position on these issues has been set forth in detail in its prior submissions. This submission, which responds to a specific request from the Uniformity Committee, is intended to supplement (but not supersede) these prior submissions.

The "Tax Equity" document and three (3) previously submitted documents ("May 16, 2011", "July 22, 2010" and "February 19, 2010") attached to this note provide detailed support for our position on this matter.

Existing Tools

Perhaps the threshold question, as was raised during the last July's Executive Committee meeting, is whether sufficient tools already exist for states to effectively deal with any true tax abuses involving insurance companies, including the Uniformity Committee's misperceived matter of tax inequity. While we appreciate the MTC and the states are in a better position to address that question, the Trades believe the states have sufficient tools to address such abuses, so that this project is not necessary .

The "Existing Tools" document attached to this note provides an overview of various tools that are currently available to states.

Revised Draft Model Language

If the Executive Committee decides to move forward with any model, the Trades believe the revised draft "Model Language" document attached to this note includes language that could be used – in a focused and targeted manner – to complement current law authorities.

Retaliatory Tax Analysis

The Trades have consistently indicated that the MTC's current version of the non-income taxpayer model language would carry real and substantial risks of triggering state retaliatory taxation. This concern has been echoed in all of the expert, third party input received by the MTC, including Professor Richard Pomp, representatives of the insurance regulatory community representing both the National Association of Insurance Commissioners (NAIC) and the Pennsylvania Insurance Department, and the Trades themselves.

The "Retaliatory Taxes" document supplements the industry's prior submissions on these retaliatory tax concerns. In addition, the "NAIC Survey" document provides a 50 state overview of retaliatory tax laws which was assembled for the Uniformity Committee by the NAIC. Both of these documents are also attached to this note.

Conclusion

We believe this submission coupled with prior submissions address the questions posed and responds to the requests made by the MTC staff, Uniformity Committee and the Executive Committee to date. We also strongly believe tax equity is not at issue here. Instead, if a new model bill is needed at all, the focus should on any abusive use of an insurance company.

Thank you and your team again for the time and effort devoted to this matter. And please feel free to contact us with any additional questions.

RETALIATORY TAX RISKS UNDER THE MTC MODEL

If the MTC adopts the Model,[1] which then is enacted by State M, there is a real and substantial risk that this new tax burden imposed by State M would trigger retaliatory taxation of State M's insurers doing business in other states. In this event, the Trades might wish to preserve their ability to argue vigorously in opposition to this practice. Thus, while the Trades could anticipate and describe the arguments a state could make to support its retaliation against the tax imposed by the Model (based on members' experiences over many years with state retaliation against a broad range of burdens), we are loathe to do so. However, what we can state at this time is that the conclusion of some in the MTC that there could be no retaliation against the Model is unfounded, inconsistent with *all outside input* received by the MTC on this question to date, and difficult to square with certain fundamentals of the retaliatory tax system.

Background: History of Retaliatory Taxation

In *Western & Southern Life Ins. Co. v. State Bd. of Equalization,* 451 U.S. 648 (1981), the U.S. Supreme Court upheld California's retaliatory tax statute against a challenge under the Equal Protection Clause. In this case, the Court observed that retaliatory tax laws are a fact of life in the existence of any insurance company that does business on a national level. Although retaliatory taxes may incidentally produce revenue, the primary purpose of these laws is to compel the foreign state imposing greater costs to lower the "premium or income or other taxes, ... fees, fines, penalties, licenses, deposit requirements or other obligations," or to remove any "prohibitions or restrictions ... imposed upon" the insurance companies of the domiciliary state. *Id.* At 668-670. Thus, when a state enacts legislation subjecting insurers to a burden that triggers retaliation by other states, the enacting state creates a tax disincentive to the jobs and investment provided by a robust domestic insurance industry, and to its insurers seeking market share in other states.

Insurance retaliatory taxes, in existence since the 19th Century and unique to the insurance tax system, were aptly described in an early decision of the Kansas Supreme Court, as follows:

> Now, our insurance laws provide that insurance corporations of other states may enter into this state and transact business upon certain limited conditions, designed only to protect the citizens of this state against irresponsible and fraudulent organizations elsewhere. In other words, this state holds itself out to all other states of the Union as willing to meet them upon a basis of substantial freedom as to all insurance transactions. It couples, however, with this general extension of freedom, a provision that if any other state shall, by its laws, hamper and restrict the privileges of corporations created under our laws, in the transaction of insurance business within its borders, the same burdens and restrictions shall be imposed upon corporations of that state seeking to transact business with us. This provision is called in insurance circles a 'retaliatory clause.' It seems to us more justly to be deemed a provision for reciprocity. It says, in effect, that while we welcome all insurance corporations of other states to the transaction of business within our limits, we insist upon a

[1] As used herein, "the Model" refers to the MTC's model bill relating to disregarded entities in its current form, "State M" refers to a state that is the insurer's domiciliary state that that enacts the Model, and "State R" refers to a retaliating state, which also is the insurer's market state .

> like welcome elsewhere, and that if other states shall attempt, directly or indirectly, to debar our corporations from the transaction of insurance business within their borders, we shall meet their corporations with the same restrictions and disability.

Phoenix Ins. Co. v. Welch, 29 Kan. 672 (1883).

Forty-nine states and the District of Columbia currently impose retaliatory taxes. Generally, retaliatory tax statues are broadly drafted so as to satisfy their overall purpose of deterring foreign states from imposing higher taxes, fees or obligations on the enacting state's domestic industry.

Attached is a 50-state survey, provided by the NAIC, of the state retaliatory laws imposed nationwide. We are not aware that the MTC has done any analysis of this survey. However, even a cursory review reflects that most retaliatory tax statutes use broad terms to define what is included and narrow terms to define what is excluded. For example, Alabama's retaliatory tax statute (at issue in *Western & Southern*) provides as follows**:**

> (a) The purpose of this section is to aid in the protection of insurers formed under the laws of Alabama and transacting insurance in other states or countries against discriminatory or onerous requirements under the laws of such states or countries or the administration thereof.
>
> (b) When by or pursuant to the laws of any other state or foreign country, any taxes, licenses and other fees, in the aggregate, and any fines, penalties, deposit requirements or other material obligations, prohibitions or restrictions are, or would be, imposed upon Alabama insurers, or upon the agents or representatives of such insurers, which are in excess of such taxes, licenses and other fees, in the aggregate, or which are in excess of the fines, penalties, deposit requirements or other obligations, prohibitions or restrictions directly imposed upon similar insurers, or upon the agents or representatives of such insurers, of such other state or country under the statutes of this state, so long as such laws of such other state or country continue in force or are so applied, the same taxes, licenses and other fees, in the aggregate, or fines, penalties or deposit requirements or other material obligations, prohibitions or restrictions, of whatever kind, shall be imposed by the commissioner upon the insurers, or upon the agents or representatives of such insurers, of such other state or country doing business or seeking to do business in Alabama. Any tax, license or other fee or other obligation imposed by any city, county or other political subdivision or agency of such other state or country on Alabama insurers, or their agents or representatives, shall be deemed to be imposed by such state or country within the meaning of this section.
>
> (c) This section shall not apply as to personal income taxes, nor as to ad valorem taxes on real or personal property nor as to special purpose obligations or assessments imposed by another state in connection with particular kinds of insurance, other than property insurance; except, that deductions from premium taxes or other taxes otherwise payable allowed on account of real estate or personal property taxes paid shall be taken into consideration by the commissioner in determining the propriety and extent of retaliatory action under this section.
> Code of Alabama, §27-3-29.

This statute takes into account any taxes, licenses and other fees, in the aggregate, and any fines, penalties, deposit requirements or other material obligations. It applies to insurers and their agents or representatives. The Alabama statute explicitly excludes only ad valorem taxes, personal income tax and certain special purpose assessments. The express, codified purpose of this statute is to protect Alabama's insurers against "discriminatory or onerous requirements under the laws" of other states in which they are doing business.

It is the nature of retaliatory taxation that whether this tax would be triggered by the Model would depend, not on the state enacting the Model, but rather on all of the other states in which insurers based in the enacting states write business. Further, states adopting the Model would have little or no influence over the way retaliating states apply their retaliatory tax statutes. It also is in the nature of retaliatory taxation that retaliatory practices tend to cascade through the nationwide insurance tax system. Thus, states are prone to amend their tax, assessment, and regulatory statutes (including retaliatory tax statutes) to respond to unconventional retaliatory tax practices, harmful to the amending state's insurers, adopted by other states. The amended statute then applies to all insurers doing business in that state, regardless where these insurers are domiciled. In short, retaliatory taxation tends to beget retaliatory taxation, so that if even a single state adopts the Model and a single state retaliates against it, the tax effects will not be confined to these two states, but will tend to ripple through other states as well.

Outside Input Received by the MTC

The insurance regulatory community has provided the MTC with input on the retaliatory tax implications of the Model. At meetings of the Uniformity Subcommittee's working group, the highly-respected Deputy Commissioner of Pennsylvania's Insurance Department (Steve Johnson) and counsel for the NAIC (Dan Schelp), both speaking on behalf of the NAIC at the MTC's invitation, opined (to the best of our recollection) that the Model could have adverse retaliatory tax consequences for insurers (with Deputy Commissioner Johnson characterizing this as a "huge" issue about which he would be "very concerned"). Other outside commentators on this issue have been in accord with this conclusion:

> *To the best of the Trades' knowledge, the Subcommittee has not conducted a comprehensive review of the threat of retaliatory taxation. As we have previously commented, the Trades have serious concerns that the threat of retaliatory taxation is very real. The draft Statutes rely on a fiction for the purpose of avoiding insurance retaliatory taxes. This fiction – that a pass-through entity is a taxable entity—applies only when the pass-through entity is by limited and defined entities including insurance companies. By singling-out insurance companies, the Draft Statues invite retaliation by the states.* [The Trades submission to the MTC (July 22, 2010)]

> *The workings of the retaliatory tax are not always fully appreciated outside the cognoscenti [footnote omitted]…Yet understanding it is critical to evaluating any proposal to change the status quo…Without appreciating the interaction between retaliatory tax and changes in existing tax rules, the best of intentions may well backfire…Any proposal…that singles out the income taxation of pass-through entities based on whether they are owned by insurance companies raises an issue of how the retaliatory tax will be applied…The law of unintended consequences should caution*

against any rush to judgment. [Professor Richard D. Pomp's submission to the MTC (March 3, 2010)]

While it was retaliatory tax risks that first caused Massachusetts to refer this project to the MTC, the Staff Analysis fails to take account of any empirical evidence relating to these risks (or even of diverse state retaliatory tax statutes and practices) Instead. The Draft Statute seeks to avoid these risks by creating a fiction; that a pass-through entity is not a pass-through entity if it's owned by an investor that is an insurance company. But the Staff Analysis fails to consider why other states should respect this fiction when it is created by an insurer's home state for the sole and express purpose of avoiding retaliatory taxes (a substantial source of revenue for lower-tax states) in these other states. And beyond the risk of states retaliating, the Staff Analysis fails to consider the implications for the state insurance tax system (and the states) if states do retaliate against the Draft Statute. [The Trades submission to the MTC (February 19, 2010)]

The Trades are aware of no outside input received by the MTC that contradicts this conclusion that adoption of the Model would pose a real and substantial threat of retaliation.

<u>MTC's "No Retaliation" Rationale</u>

Those in the MTC who conclude that the Model would not trigger a state's retaliatory tax, have relied solely on the following (apparently related) conclusions:

- Since the Model imposes tax directly on the pass-through entity rather than the insurer/investor, retaliating states could not view this tax as an insurer burden under their retaliatory tax statutes.

- Since income taxes imposed on insurer investments in corporations have not historically triggered retaliatory taxes, neither would income taxes imposed by the Model on insurer investments in LLCs, partnerships, and other disregarded entities.

As to the first conclusion, although the Model imposes tax on the pass-through entity and not on the insurer in form, it is clear that the Model is designed to tax insurer investment income in substance. The history of the Model (initially referred to the MTC by Massachusetts' Revenue Commissioner) reflects that when Massachusetts first proposed to tax the income earned by insurance company investments in pass-through entities, the tax was imposed directly upon insurers. When retaliatory tax concerns were raised, the response was to modify the proposal to impose the tax on the pass-through entity rather than the insurer. Thus, imposition of the tax under the Model was shifted from the insurer to the pass-through entity solely for the purpose of avoiding retaliatory taxation.

With the MTC and the NAIC now actively engaged in this project, it would be unlikely to escape the attention of insurance tax regulators that the history of the Massachusetts' proposal and the Model reflect that these proposals are aimed at investors that are insurance companies. We have seen no MTC response to the question raised in our prior testimony (excerpted above), as to whether (or why) the MTC expects that State R would respect a tax fiction adopted by State M solely and expressly for the purpose of avoiding State R's retaliatory tax statute.

Moreover, the MTC's stated tax equity rationale for the Model puts the focus on the absence of corporate income tax collected on this investment income at the level of the insurance company, not the disregarded entity. The fact that this investment income is not subject to tax at the level of the insurance company investor (because it pays a gross premiums tax in lieu of an income tax), but would be subject to tax at the level of another corporate investor (because it pays income tax, but not a gross premiums tax) is the *sine qua non* of the Model. Thus, the Model is premised on taxation, not of the pass-through entity, but of the insurance company. It seems likely that this would be a persuasive consideration in a state's decision to retaliate.

And as for the second conclusion, it is true that there is no retaliation today against income tax imposed on non-insurance corporations in which insurers invest. This is because the taxation of corporate income is a basic and uniform principle of the state (and federal) income tax system. It is the effect of insurance retaliatory taxation to level insurance tax imbalances among states. Since most all states will tax the income of such corporate entities, there is no fundamental imbalance here between State R and State M that would be likely to prompt the invocation of retaliatory taxation.

It also is a basic principle of the income tax system that the income of a "disregarded entity" is disregarded at the entity level. Taxing this income to the otherwise-disregarded entity constitutes a deviation from income tax norms. When State R sees its home state insurers taxed by State M in a manner that deviates from the norms of the corporate income tax system (by taxing partnerships, LLCs, and other otherwise-disregarded entities), as well as the insurance tax system (by taxing investment income), there is no reason to expect that State R will refrain from treating insurers from State M – under the authority of its retaliatory tax – in a like manner. And here again, the nature of retaliation means that these tax effects, once set in motion, are not likely to remain confined to two states.

Lastly, it bears noting that in states that already apply income taxes to insurance companies (e.g., Illinois), the income from single-member LLCs already is subject to income tax and that this income tax is retaliated against by other states.

Conclusion

All outside experts consulted by the MTC are in accord that a state's adoption of the Model would carry a real and substantial risk of triggering insurance retaliatory taxation. Some in the MTC disagree.

The MTC should conduct a fair and expeditious survey of state regulators who administer insurance retaliatory taxes to ask if there is a risk that the model, if adopted by a state, would be retaliated against. The results of this survey would replace unfounded speculation with empirical evidence based on the responses of state insurance and tax regulators – all now at the table on this project -- about retaliatory tax risks under the Model, bringing clarity to the MTC's unresolved questions in this area.

Model Language

(a) When more than 50 per cent of the capital interests or profits interest in an entity for which deductions would be allowed under section 162 of the Internal Revenue Code, 26 U.S.C. 162 and that would otherwise be treated as a partnership or disregarded entity for purposes of the corporate tax law is owned directly by a disqualified insurance company as defined in subpart (b), the partnership or disregarded entity shall be taxed as if the partnership or disregarded entity were a corporation subject to tax under chapter [*insert state statute]* to the extent of the distributive share of the disqualified insurance company. To the extent applicable, income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes and activities, shall be included and taken into account in a combined report filed under [*insert state statute*].

(b) For purposes of this section only, a disqualified insurance company is defined to mean

i. An entity that does not qualify for treatment as a life insurance company as defined in section 816 of the Internal Revenue Code of 1986 or as an insurance company as defined in section 831(c) of the Internal Revenue Code, or

ii. An entity that would not qualify for treatment as a life insurance company as defined in section 816 of the Internal Revenue Code of 1986 or as an insurance company as defined in section 831(c) of the Internal Revenue Code if that entity was deemed to directly own assets that it actually owns indirectly though its 50% or more investment in a partnership or disregarded entity, or

iii. An entity where the investment in the partnership or disregarded entity is not an admitted asset on the insurance company's books as defined by the National Association of Insurance Commissioners ("NAIC").

Existing Tools to Address MTC Concerns
Relating to Certain Income Tax Abuses/Inequities

1) Roughly 50% of the states have authority to require combined reports for unitary groups. Depending on the state, this authority may allow for inclusion of an insurance company in a combined report with its non-insurance company affiliates.

2) Section 2.B of MTC's Combined Report Model (approved on August 17, 2006) allows for the inclusion of insurance companies in a combined report with their non-insurance company affiliates in certain instances.

3) Roughly ten (10) states subject the insurance company to income tax in addition to premium tax. Generally, those states allow credits for the income taxes against the insurer's premium taxes. In these situations, the insurer is subject to corporate income taxation on the income of a pass-through entity in which it invests.

4) Most states, whether requiring separate company or combined reporting, have statutes, regulations or both that provide the Director or Commissioner of Taxation broad discretionary authority to make a range of adjustments to properly reflect tax when a company has arranged or conducts its business in a manner for which the primary purpose is tax evasion.

5) California law requires a reduction or disallowance of a deduction for dividends received from an overcapitalized insurance company.

6) Judicial doctrines such as sham transaction, economic substance or business purpose may be available to states to challenge tax evasion involving any misuse of insurance companies for state income tax purposes.